

2(c)(1) for provisions relating to the carryover of losses and deductions with respect to a former shareholder of S2 that may be available to that shareholder as a shareholder of S1.

(d) *Examples.* The following examples illustrate the application of this section:

Example 1. X, an S corporation, owns 100 percent of the stock of Y, a C corporation. On June 2, 2002, X makes a valid QSub election for Y, effective June 2, 2002. Assume that, under general principles of tax law, including the step transaction doctrine, X's acquisition of the Y stock and the subsequent QSub election would not be treated as related. The liquidation described in paragraph (a)(2) of this section occurs at the close of the day on June 1, 2002, the day before the QSub election is effective, and the plan of liquidation is considered adopted on that date. Y's taxable year and separate existence for Federal tax purposes end at the close of June 1, 2002.

Example 2. X, a C corporation, owns 100 percent of the stock of Y, another C corporation. On December 31, 2002, X makes an election under section 1362 to be treated as an S corporation and a valid QSub election for Y, both effective January 1, 2003. Assume that, under general principles of tax law, including the step transaction doctrine, X's acquisition of the Y stock and the subsequent QSub election would not be treated as related. The liquidation described in paragraph (a)(2) of this section occurs at the close of December 31, 2002, the day before the QSub election is effective. The QSub election for Y is effective on the same day that X's S election is effective, and the deemed liquidation is treated as occurring before the S election is effective, when X is still a C corporation. Y's taxable year ends at the close of December 31, 2002. See § 1.381(b)-1.

Example 3. On June 1, 2002, X, an S corporation, acquires 100 percent of the stock of Y, an existing S corporation, for cash in a transaction meeting the requirements of a qualified stock purchase (QSP) under section 338. X immediately makes a QSub election for Y effective June 2, 2002, and also makes a joint election under section 338(h)(10) with the shareholder of Y. Under section 338(a) and § 1.338(h)(10)-1(d)(3), Y is treated as having sold all of its assets at the close of the acquisition date, June 1, 2002. Y is treated as a new corporation which purchased all of those assets as of the beginning of June 2, 2002, the day after the acquisition date. Section 338(a)(2). The QSub election is effective on June 2, 2002, and the liquidation under paragraph (a)(2) of this section occurs immediately after the deemed asset purchase by the new corporation.

Example 4. X, an S corporation, owns 100 percent of Y, a corporation for which a QSub election is in effect. On May 12, 2002, a date on which the QSub election is in effect, X issues Y a \$10,000 note under state law that matures in ten years with a market rate of interest. Y is not treated as a separate corporation, and X's issuance of the note to Y on May 12, 2002, is disregarded for Federal tax purposes.

Example 5. X, an S corporation, owns 100 percent of the stock of Y, a C corporation. At a time when Y is indebted to X in an amount that exceeds the fair market value of Y's assets, X makes a QSub election effective on the date it is filed with respect to Y. The liquidation described in paragraph (a)(2) of this section does not qualify under sections 332 and 337 and, thus, Y recognizes gain or loss on the assets distributed, subject to the limitations of section 267.

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§ 1.1361-5 Termination of QSub election.

(a) In general—(1) *Effective date.* The termination of a QSub election is effective—

(i) On the effective date contained in the revocation statement if a QSub election is revoked under § 1.1361-3(b);

(ii) At the close of the last day of the parent's last taxable year as an S corporation if the parent's S election terminates under § 1.1362-2; or

(iii) At the close of the day on which an event (other than an event described in paragraph (a)(1)(ii) of this section) occurs that renders the subsidiary ineligible for QSub status under section 1361(b)(3)(B).

(2) *Information to be provided upon termination of QSub election by failure to qualify as a QSub.* If a QSub election terminates because an event renders the subsidiary ineligible for QSub status, the S corporation must attach to its return for the taxable year in which the termination occurs a notification that a QSub election has terminated, the date of the termination, and the names, addresses, and employer identification numbers of both the parent corporation and the QSub.

(3) *QSub joins a consolidated group.* If a QSub election terminates because the S corporation becomes a member of a consolidated group (and no election

under section 338(g) is made) the principles of § 1.1502-76(b)(1)(ii)(A)(2) (relating to a special rule for S corporations that join a consolidated group) apply to any QSub of the S corporation that also becomes a member of the consolidated group at the same time as the S corporation. See *Example 4* of paragraph (a)(4) of this section.

(4) *Examples. The following examples illustrate the application of this paragraph (a):*

Example 1. Termination because parent's S election terminates. X, an S corporation, owns 100 percent of Y. A QSub election is in effect with respect to Y for 2001. Effective on January 1, 2002, X revokes its S election. Because X is no longer an S corporation, Y no longer qualifies as a QSub at the close of December 31, 2001.

Example 2. Termination due to transfer of QSub stock. X, an S corporation, owns 100 percent of Y. A QSub election is in effect with respect to Y. On December 10, 2002, X sells one share of Y stock to A, an individual. Because X no longer owns 100 percent of the stock of Y, Y no longer qualifies as a QSub. Accordingly, the QSub election made with respect to Y terminates at the close of December 10, 2002.

Example 3. No termination on stock transfer between QSub and parent. X, an S corporation, owns 100 percent of the stock of Y, and Y owns 100 percent of the stock of Z. QSub elections are in effect with respect to both Y and Z. Y transfers all of its Z stock to X. Because X is treated as owning the stock of Z both before and after the transfer of stock solely for purposes of determining whether the requirements of section 1361(b)(3)(B)(i) and § 1.1361-2(a)(1) have been satisfied, the transfer of Z stock does not terminate Z's QSub election. Because the stock of Z is disregarded for all other Federal tax purposes, no gain is recognized under section 311.

Example 4. Termination due to acquisition of S parent by a consolidated group. X, an S corporation, owns 100 percent of Y, a corporation for which a QSub election is in effect. Z, the common parent of a consolidated group of corporations, acquires 80 percent of the stock of X on June 1, 2002. Z does not make an election under section 338(g) with respect to the purchase of X stock. X's S election terminates as of the close of the preceding day, May 31, 2002. Y's QSub election also terminates at the close of May 31, 2002. Under § 1.1502-76(b)(1)(ii)(A)(2) and paragraph (a)(3) of this section, X and Y become members of Z's consolidated group of corporations as of the beginning of the day June 1, 2002.

Example 5. Termination due to acquisition of QSub by a consolidated group. The facts are the same as in Example 4, except that Z acquires 80 percent of the stock of Y (instead of

X) on June 1, 2002. In this case, Y's QSub election terminates as of the close of June 1, 2002, and, under § 1.1502-76(b)(1)(ii)(A)(1), Y becomes a member of the consolidated group at that time.

(b) *Effect of termination of QSub election—(1) Formation of new corporation—*

(i) *In general.* If a QSub election terminates under paragraph (a) of this section, the former QSub is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the termination from the S corporation parent in exchange for stock of the new corporation. The tax treatment of this transaction or of a larger transaction that includes this transaction will be determined under the Internal Revenue Code and general principles of tax law, including the step transaction doctrine. For purposes of determining the application of section 351 with respect to this transaction, instruments, obligations, or other arrangements that are not treated as stock of the QSub under § 1.1361-2(b) are disregarded in determining control for purposes of section 368(c) even if they are equity under general principles of tax law.

(ii) *Termination for tiered QSubs.* If QSub elections terminate for tiered QSubs on the same day, the formation of any higher tier subsidiary precedes the formation of its lower tier subsidiary. See Example 6 in paragraph (b)(3) of this section.

(2) *Carryover of disallowed losses and deductions.* If a QSub terminates because the S corporation distributes the QSub stock to some or all of the S corporation's shareholders in a transaction to which section 368(a)(1)(D) applies by reason of section 355 (or so much of section 356 as relates to section 355), see § 1.1366-2(c)(2) for provisions relating to the carryover of disallowed losses and deductions that may be available.

(3) *Examples.* The following examples illustrate the application of this paragraph (b):

Example 1. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X sells 21 percent of the Y stock to Z, an unrelated corporation, for cash, thereby terminating the QSub election. Y is treated as a new corporation acquiring all of its assets (and assuming all

of its liabilities) in exchange for Y stock immediately before the termination from the S corporation. The deemed exchange by X of assets for Y stock does not qualify under section 351 because X is not in control of Y within the meaning of section 368(c) immediately after the transfer as a result of the sale of stock to Z. Therefore, X must recognize gain, if any, on the assets transferred to Y in exchange for its stock. X's losses, if any, on the assets transferred are subject to the limitations of section 267.

Example 2. (i) X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. As part of a plan to sell a portion of Y, X causes Y to merge into T, a limited liability company wholly owned by X that is disregarded as an entity separate from its owner for Federal tax purposes. X then sells 21 percent of T to Z, an unrelated corporation, for cash. Following the sale, no entity classification election is made under § 301.7701-3(c) of this chapter to treat the limited liability company as an association for Federal tax purposes.

(ii) The merger of Y into T causes a termination of Y's QSub election. The new corporation (Newco) that is formed as a result of the termination is immediately merged into T, an entity that is disregarded for Federal tax purposes. Because, at the end of the series of transactions, the assets continue to be held by X for Federal tax purposes, under step transaction principles, the formation of Newco and the transfer of assets pursuant to the merger of Newco into T are disregarded. The sale of 21 percent of T is treated as a sale of a 21 percent undivided interest in each of T's assets. Immediately thereafter, X and Z are treated as contributing their respective interests in those assets to a partnership in exchange for ownership interests in the partnership.

(iii) Under section 1001, X recognizes gain or loss from the deemed sale of the 21 percent interest in each asset of the limited liability company to Z. Under section 721(a), no gain or loss is recognized by X and Z as a result of the deemed contribution of their respective interests in the assets to the partnership in exchange for ownership interests in the partnership.

Example 3. Assume the same facts as in *Example 1*, except that, instead of purchasing Y stock, Z contributes to Y an operating asset in exchange for 21 percent of the Y stock. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) in exchange for Y stock immediately before the termination. Because X and Z are co-transferors that control the transferee immediately after the transfer, the transaction qualifies under section 351.

Example 4. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X distributes all of the Y stock pro rata to its share-

holders, and the distribution terminates the QSub election. The transaction can qualify as a distribution to which sections 368(a)(1)(D) and 355 apply if the transaction otherwise satisfies the requirements of those sections.

Example 5. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X subsequently revokes the QSub election. Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) immediately before the revocation from its S corporation parent in a deemed exchange for Y stock. On a subsequent date, X sells 21 percent of the stock of Y to Z, an unrelated corporation, for cash. Assume that under general principles of tax law including the step transaction doctrine, the sale is not taken into account in determining whether X is in control of Y immediately after the deemed exchange of assets for stock. The deemed exchange by X of assets for Y stock and the deemed assumption by Y of its liabilities qualify under section 351 because, for purposes of that section, X is in control of Y within the meaning of section 368(c) immediately after the transfer.

Example 6. (i) X, an S corporation, owns 100 percent of the stock of Y, and Y owns 100 percent of the stock of Z. Y and Z are corporations for which QSub elections are in effect. X subsequently revokes the QSub elections and the effective date specified on each revocation statement is June 26, 2002, a date that is less than 12 months after the date on which the revocation statements are filed.

(ii) Immediately before the QSub elections terminate, Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from X in exchange for the stock of Y. Z is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from Y in exchange for the stock of Z.

Example 7. (i) The facts are the same as in *Example 6*, except that, prior to June 26, 2002 (the effective date of the revocations), Y distributes the Z stock to X under state law.

(ii) Immediately before the QSub elections terminate, Y is treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from X in exchange for the stock of Y. Z is also treated as a new corporation acquiring all of its assets (and assuming all of its liabilities) directly from X in exchange for the stock of Z.

Example 8. Merger of parent into QSub. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. X merges into Y under state law, causing the QSub election for Y to terminate, and Y survives the merger. The formation of the new corporation, Y, and the merger of X into Y can qualify as a reorganization described in section 368(a)(1)(F) if

the transaction otherwise satisfies the requirements of that section.

Example 9. Transfer of 100 percent of QSub. X, an S corporation, owns 100 percent of the stock of Y, a corporation for which a QSub election is in effect. Z, an unrelated C corporation, acquires 100 percent of the stock of Y. The deemed formation of Y by X (as a consequence of the termination of Y's QSub election) is disregarded for Federal income tax purposes. The transaction is treated as a transfer of the assets of Y to Z, followed by Z's transfer of these assets to the capital of Y in exchange for Y stock. Furthermore, if Z is an S corporation and makes a QSub election for Y effective as of the acquisition, Z's transfer of the assets of Y in exchange for Y stock, followed by the immediate liquidation of Y as a consequence of the QSub election are disregarded for Federal income tax purposes.

(c) *Election after QSub termination*—(1) *In general.* Absent the Commissioner's consent, and except as provided in paragraph (c)(2) of this section, a corporation whose QSub election has terminated under paragraph (a) of this section (or a successor corporation as defined in § 1.1362-5(b)) may not make an S election under section 1362 or have a QSub election under section 1361(b)(3)(B)(ii) made with respect to it for five taxable years (as described in section 1361(b)(3)(D)). The Commissioner may permit an S election by the corporation or a new QSub election with respect to the corporation before the five-year period expires. The corporation requesting consent to make the election has the burden of establishing that, under the relevant facts and circumstances, the Commissioner should consent to a new election.

(2) *Exception.* In the case of S and QSub elections effective after December 31, 1996, if a corporation's QSub election terminates, the corporation may, without requesting the Commissioner's consent, make an S election or have a QSub election made with respect to it before the expiration of the five-year period described in section 1361(b)(3)(D) and paragraph (c)(1) of this section, provided that—

(i) Immediately following the termination, the corporation (or its successor corporation) is otherwise eligible to make an S election or have a QSub election made for it; and

(ii) The relevant election is made effective immediately following the termination of the QSub election.

(3) *Examples.* The following examples illustrate the application of this paragraph (c):

Example 1. Termination upon distribution of QSub stock to shareholders of parent. X, an S corporation, owns Y, a QSub. X distributes all of its Y stock to X's shareholders. The distribution terminates the QSub election because Y no longer satisfies the requirements of a QSub. Assuming Y is otherwise eligible to be treated as an S corporation, Y's shareholders may elect to treat Y as an S corporation effective on the date of the stock distribution without requesting the Commissioner's consent.

Example 2. Sale of 100 percent of QSub stock. X, an S corporation, owns Y, a QSub. X sells 100 percent of the stock of Y to Z, an unrelated S corporation. Z may elect to treat Y as a QSub effective on the date of purchase without requesting the Commissioner's consent.

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§ 1.1361-6 Effective date.

Except as provided in §§ 1.1361-4(a)(3)(iii), 1.1361-4(a)(5)(i), 1.1361-4(a)(6)(iii), 1.1361-4(a)(7)(ii), 1.1361-4(a)(8)(ii), 1.1361-4(a)(9), and 1.1361-5(c)(2), the provisions of §§ 1.1361-2 through 1.1361-5 apply to taxable years beginning on or after January 20, 2000; however, taxpayers may elect to apply the regulations in whole, but not in part (aside from those sections with special dates of applicability), for taxable years beginning on or after January 1, 2000, provided all affected taxpayers apply the regulations in a consistent manner. To make this election, the corporation and all affected taxpayers must file a return or an amended return that is consistent with these rules for the taxable year for which the election is made. For purposes of this section, affected taxpayers means all taxpayers whose returns are affected by the election to apply the regulations.

[T.D. 8869, 65 FR 3854, Jan. 25, 2000, as amended by T.D. 9356, 72 R 45893, Aug. 16, 2007; T.D. 9422, 73 FR 47530, Aug. 14, 2008]